Supreme Court, U.S.
FILED
DEC 1 1995
CLERK

(4)

NO. 95-436

IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

MACH-TECH, LTD. PARTNERSHIP and SERV-TECH, INC., Tax Matters Partner
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITIONERS' RESPONSE TO RESPONDENT'S BRIEF IN OPPOSITION

LARRY E. JACOBS
NORTON, JACOBS, KUHN & MCTOPY, L.L.P.
1111 Bagby
Suite 2450
Houston, Texas 77002
(713) 659-1131
Attorney for Petitioners

Of Counsel:
RUTH E. SALEK
1200 Smith Street.
Suite 1300
Houston, Texas 77002

Alpha Law Brief Company • Houston, Texas • (713) 981-9000 • 1-800-981-9001

13 pp

TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

ARGUMENT 1

CONCLUSION 10

TABLE OF AUTHORITIES

Cases **Pages**

Harris v. Commissioner,
16 F.3d 75 (5th Cir.1994) 3, 6

Kantor v. Commissioner,
998 F.2d 1514 (9th Cir. 1993) 8

Scoggins v. Commissioner,
46 F.3d. 950 (9th Cir. 1995) 2, 7, 8

Smith v. Commissioner,
937 F.2d. 1089 (6th Cir. 1991) 2, 7

Snow v. Commissioner,
414 U.S. 500 (1974) . . . . . passim

Statutes and Regulations

26 U.S.C.A. §162 6

26 U.S.C.A. §174 . . . . . passim

Other

The Black's Law Dictionary 4

NO. 95-436

IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

MACH-TECH, LTD. PARTNERSHIP and SERV-TECH, INC., Tax Matters Partner,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITIONERS' RESPONSE TO RESPONDENT'S BRIEF IN OPPOSITION

ARGUMENT

In its Brief for the Respondent in Opposition ("Opposing Brief"), the government subliminally acknowledges that the legal question presented by Petitioners has not been addressed by this Court, and is not consistently applied by the Circuit Courts of Appeals. This silent acknowledgment is found in government phrases such as "[n]othing in *Snow* addressed..."(Opposing Brief p. 10), and when referring to the Sixth and Ninth Circuit conflict with the Fifth Circuit opinion herein, "[t]hese cases are readily distinguishable (Opposing Brief p.11). Unfortunately, the government's intellectual integrity ends with such phrases, and it asks this Court to ignore the missing standard and confusing Circuit case law by attempting to hide this important legal question with the ever variable facts. No one

now knows the precise ownership facts in *Snow v Commissioner*, 416 U.S. 500 (1974) sufficiently to say whether the limited partners therein maintained a controlling interest. But even the government acknowledges this Court did not address in *Snow*, or any other opinion, the level of control necessary when seeking a §174 deduction. Yes, in *Smith v Commissioner*, 937 F.2d 1089 (6th Cir. 1991) and *Scoggins v Commissioner*, 46 F.3d 950 (9th Cir. 1995) the facts varied from Petitioners' herein. But those variations in facts cannot be used to "distinguish" the Sixth and Ninth Circuit cases from this case when the legal issue has nothing to do with the differentiating facts. Only the level of control needed at the end of the day is at issue, not the extraneous "fact bound" trivia relied upon by the government. Indeed, § 174 cases are "fact-bound," but the standard Petitioners ask this Court to establish is a legal standard... the level of control needed to be entitled to the §174 deduction. This standard is important, has never been established by this Court, and the vacuum created by the lack of a standard generates a significant disparity in the treatment of taxpayers in the Sixth, Ninth, and Fifth Circuits.

1. The government's first attempt to.hide the important legal issue presented by this case is found in its statement of the question presented for review. Petitioners state a clearly legal question for review, "whether the Fifth Circuit used the correct standard of control in determining if the requirements of §174 of the Internal Revenue Code were met." The government, on the other hand, gives the question as "whether the research and development expenditures involved in this case were made 'in connection with [a] trade or business' of the taxpayer within the meaning of §174 of the Internal Revenue Code." Thus, on its opening page, the government attempts to hide the law with the facts.

Obviously, the ultimate issue is whether the claimed §174 deduction is allowable. The problem presented to this court however is the legal standard to be used in applying the facts... not the factual analysis. The Fifth Circuit opinion herein established a legal doctrine with its "actually managed and actually controlled" test. It is this legal doctrine and/or test which Petitioners bring before this Court for review, and not the facts of this case.[1] To prove the Fifth Circuit opinion, for which certiorari is sought, establishes a legal, not factual test, Petitioners quote the controlling language from the Fifth Circuit opinion:

> According to *Harris [v Commissioner*, 16 F.3d 75 (5th Cir. 1994)*]*, a dispositive factor in determining whether a § 174 deduction is warranted is whether "the entity that incurred the research expenses **actually managed and actually controlled the use or marketing of the research results.**" *Id.* at 80. Despite Serv-Tech's "attribution" arguments, it is clear that the Tax Court did not err in finding that **Mach-Tech, with its 7.5% interest in Serv-Tech after the merger, could not exercise the control over the exploitation of the technology as required by *Snow* and *Harris*.** (Pet. App. 5a, 6a) [emphasis added].

We do not see how it is possible to draw any conclusion from this statement other than the Fifth Circuit has adopted a legal test of ongoing control as a condition for

---

[1] We also think that, once the correct legal doctrine has been established, the Partnership is entitled to the deduction based upon the stipulated facts.

the §174 deduction.[2] A "factor" is not a fact; in this instance, it is an "influence which brings about or contributes to a result..." Black's Law Dictionary 532 (5ed. 1979).

The government tries to circumvent this dilemma by classifying the decision in this case as a factual determination under the "realistic prospect' portion of the tests enunciated to date. This argument fails because the realistic prospect test is not the only test for deductibility, and it has nothing to do with the issue presented to this Court. It is in fact only the second leg of the true test, the "at any time test." The Fifth Circuit agreed with us on this legal point, but affirmed on the basis of the limited partners' post merger ownership percentages. The type of ownership (stock) was sufficient; the limited partners just did not own enough of it.[3] Thus, the Fifth Circuit opinion turned on the legal issue before this Court... what level of control is needed to be entitled to the §174 deduction.

2. In its second argument, the government tries to hide the legal issue by contending that this case and *Snow* are not

---

[2] There is no doubt this is what the Fifth Circuit meant when one considers the portion of the opinion from which this quote came. See, Pet. App. 5a, first two sentences.

[3] We know this to be the case for two reasons. First, the *Snow* limited partners ended up owning stock; thus stock ownership is surely the right type of ownership. Second, the second paragraph of the Fifth Circuit's opinion commencing with, "A small body of case law..." is almost a verbatim quote from our opening Brief in which we outlined the two conditions under which the deduction could be granted as follows: "if the taxpayer is engaged in a trade or business at any time...[, or if] no trade or business is found to have been conducted by the taxpayer, ...[was] there a 'realistic prospect' that the technology will or would have been exploited in the taxpayer's trade or business.(Pet. App. 2a; Petitioner's Opening Brief Fifth Circuit, p.12)

factually similar. This argument is based solely on the government's contention that the successor corporation in *Snow* was nothing more than a mere change in form. Where in the *Snow* record is ownership in the successor corporation disclosed? It is not known. The only known fact is that the *Snow* partnership was out of money at the end of the development period. Thus, there is every reason to believe that additional capital was invested in the successor corporation to commence manufacturing. It is highly unlikely such capital was provided gratuitously. In other words, there had to be ownership changes in *Snow*.

The government compounds the error of its unsupported factual assertion that there was no ownership diminution in *Snow* by arguing Petitioners allege *Snow* stands for the proposition that no control over the technology is required. The government's Opposing Brief at page 9 says:

> Petitioner contends that the ability of the taxpayer to control the development and implement future exploitation of the technology was not required by *Snow*.

Petitioners have said and continue to argue exactly the opposite! Quoting our Petition on page 14:

> What the *Snow* partners did have was the right to decide which of several avenues would be chosen for the commercialization of the developed technology, i.e. "strategic control."

It is the government that is trying to alter the meaning of *Snow*. The government interprets *Snow* in conflict with its known facts in an attempt to distinguish it from this case. Quoting the government on page 10 of the Opposing Brief:

> The requirement that there be a realistic prospect that the taxpayer--rather than some other entity--will exploit the invention is imposed by Section 174 itself, for the statute requires the taxpayer to incur the research expenses in connection with "his" trade or business....Nothing in *Snow* addressed, much less eliminated this statutory requirement. There is thus no conflict...

It is incredible that the government can make such a statement. The entire issue in *Snow* was whether that limited partnership could claim the §174 deduction when the trade or business was carried on by a successor in interest, **a different taxpayer** in any circumstance. The very fact that this Court allowed the deduction to Edwin Snow (via the limited partnership) when the trade or business was conducted by a successor corporation renders the government's argument incorrect and misleading. Furthermore, the government did not carefully read this Court's discussion in *Snow* about the meaning of trade or business for purposes of §174. See, *Snow*, 416 U.S. at 502. The government argues a §162 type approach to the meaning of trade or business, something this Court expressly rejected in *Snow*. The Fifth Circuit came close to defining "trade or business" for purposes of §174 with its operational nexus discussion in *Harris*, but deprived it of any meaning by imposing a continuing controlling interest standard. It is this legal standard Petitioners now question. The government's erroneous interpretation of the Fifth Circuit's opinion on the meaning of control makes it very clear the Petition should be granted. Guidance is definitely lacking.

Snow does not stand for ongoing control, even though that is what the government argues it means. It can't mean ongoing control because, as the government admits, the issue of the degree of control was not addressed in *Snow*.

The government's assertion of no conflict means it intends to interpret *Snow* as requiring ongoing control. Failure to grant the Petition in light of this fact will serve as a green light for the government to impose an ongoing control requirement for §174. As a matter of law and policy, this issue is too important for government fiat to establish this new requirement.

3. The government misleads this Court by arguing that the conflict in Circuits can be distinguished by the facts. While many facts distinguish this case and *Smith v Commissioner*, 937 F.2d 1089 (6th Cir. 1991), none are relevant to the legal issue under consideration. The existence of the royalty option in this case and the lack thereof in *Smith* has nothing to do with the conflict. Using it as a distinguishing factor is a red herring that only serves to confuse matters.

The conflict between Petitioners' case and *Smith* is that in *Smith*, the deduction was allowed even though it was determined that the technology would be exploited by a successor joint venture, which of course would not be the same taxpayer, and which would not be controlled, within the Fifth Circuit's meaning of control, by the *Smith* partnership. The expert report, on which the case rested, concluded that it was likely that the strategic partner, and not the *Smith* partnership, would control the successor joint venture because it had the expertise. If the Sixth Circuit standard of control had been applied by the Fifth Circuit in this case, Petitioner's §174 deduction would have been allowed. The conflict lies in the standard of control used by the Fifth Circuit, but not the Sixth Circuit. Relevant facts cannot distinguish the two cases on this point.

The conflict between Petitioners' case and *Scoggins v Commissioner*, 46 F.3d 950 (9th Cir. 1995) is not whether the purchase option would be exercised, but the control given

the partners of the *Scoggins* partnership via attribution from their position as shareholders of the option holding corporation. This same control attribution was denied Mr. Krajicek in this case. A fortiori, in this case, it was held against him. Quoting *Scoggins,* 46 F.3d at 955:

> The contrast of the composition of the two entities in each case is also significant. In *Kantor [v Commissioner*, 998 F.2d 1514 (9th Cir. 1993)*]*, the partnership contracted with a completely independent research firm. Although the general partner, Hubert, monitored the research, neither he nor the partnership had any ownership or official position in the research firm. In this *case* [*Scoggins*], the partnership and the corporation were controlled and financed by Scoggins and Christensen. It was these partners who would have to be willing to raise $5 million on behalf of the corporation in order for the corporation to able to continue to market the reactor after the 15 month nonexclusive license expired.

The control was in the hands of the partners in their capacity as shareholders of the corporation. It was the partners acting in their capacity as shareholders who were to make the decision whether or not to exercise the purchase option, and not the partnership. It is this control attribution which creates the conflict because the purchase contract literally allowed the *Scoggins* partnership no say in the exploitation of its technology; therefore the *Scoggins* partnership had no control in its own right. Control existed only through the common partnership/corporate ownership. Both the Tax Court and the Fifth Circuit held against

Petitioners with respect to Mr Krajicek's common partnership/corporate ownership.

4. Finally, the government has totally ignored the policy issues at stake in this case. While admitting this Court has yet to address the issue of the degree of control, the government made no comment about what degree of control should be required. Petitioners went into considerable detail about the business realities of venture capital investing because this Court must be informed on the reality of the marketplace. Only with reality based reasoning can the policy behind §174 be correctly considered. Petitioners have not asked this Court to take their word for these business realities. Instead, we brought to this Court's attention views of the leading scholars in the field. Further, Information Technology Association of America, a major organization whose members are constantly involved in research and development, have filed a brief in support of Petitioners. The government, on the other hand, hides behind irrelevant facts, and does not address the real economic policy which lead to enactment of §174. Could it be the government only wants to win, rather than find the correct legal standard? The ongoing level of control required for §174 is a legal issue which has not been addressed by this Court. It is a standard important to Petitioners and to many members of our economic community. The government does both the taxpayers and this Court an injustice by attempting to hide this important legal issue with irrelevant facts.

CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully Submitted,

LARRY E. JACOBS
NORTON, JACOBS, KUHN
& MCTOPY, L.L.P.
1111 Bagby
Suite 2450
Houston, Texas 77002
(713) 659-1131
Attorney for Petitioners

Of Counsel:
RUTH E. SALEK
1200 Smith Street.
Suite 1300
Houston, Texas 77002